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## Rating agencies

### RISKS BEYOND MEASURE

Investors are blaming the ratings agencies for failing to Alert them sooner to the severity of the problems in Asian economies. They have a point

Dateline: NEW YORK

ASIA'S financial crises have cost investors dear. As always on such occasions, the search is on for somebody to blame. Among the leading suspects are the firms that rate the creditworthiness of bond issuers. The raters, firms such as Moody's Investors Service, Standard & Poor's, Duff & Phelps and IBCA, are supposed to be the financial markets' early-warning system. Instead, the agencies have spent the past few months belatedly reacting to events. On December 10th, Moody's seemed deliberately to prove the point: it declared that no South Korean bonds now qualify as "investment grade"-long after the press had reported that Korea's central bank was nearly out of foreign-currency reserves.

Not guilty, say the raters. They point out that Asian debt was never given the top rating bestowed on that issued in leading industrial economies. In any case, they note, no Asian government, and no Asian company whose bonds ever held an investment-grade rating, has yet failed to pay bondholders on time. This is true, as far as it goes. But it does not get the agencies off the hook. They are at the very least guilty of badly misreading Asian politics and of failing to spell out the questionable assumptions that sometimes underpin their ratings. And, perhaps, of misunderstanding where some of the real risks in financial markets lie.

In country after country, it has often been a case of too little, too late. The agencies are continuing to downgrade Japanese financial institutions for reasons that have been widely commented upon for months, if not years. The credit markets had long since closed their doors to Yamaichi, a Japanese securities house, when both Moody's and S&P downgraded it just before it went bankrupt on November 21st. In Hong Kong, it was only after the Hang Seng stock index crashed in late October that Moody's (but not S&P) put forth a "negative outlook" on some leading Hong Kong banks-a bit late for investors who had viewed Hong Kong as a haven in Asia's storms.

In South Korea, both leading agencies did give fair warning of the severity of the banks' problems. However, they were slow to downgrade the government's debt; when they did, in October, when the prospect of an IMF bail-out was looming, they still declared Korea's sovereign debt to be investment grade-a rating that makes it a permitted investment for thousands of American mutual funds and pension plans.

S&P was slightly quicker than its main rival to signal concerns about South Korea. In Thailand, by contrast, Moody's was

- the more alert. Having trimmed short-term ratings in September 1996, it lowered long-term ratings in April. S&P reaffirmed its rating around the same time, explaining: "People say, in Mexico, the currency crashed, there was a financial crisis involving the government, so why can't that happen in Thailand? The answer is very simple. Because the fiscal position and financial position of Thailand is fundamentally different from that of Mexico."

Only in October, three months after the collapse of the Thai currency, the baht, and two months after the Thai government sought aid from the IMF, did the two agencies strip the A-rating from the government's bonds. It took another six weeks and the prime minister's resignation before the two agencies conceded that Thai bonds were beginning to look like junk bonds.

There are plenty more examples. Edward Altman, an *economist* at New York University, says the raters suffer from "downward rigidity". When they determine that a bond issuer's creditworthiness has improved and upgrade the bonds, he says, the next rating change is equally likely to be up or down. A downgrade, however, is far more likely to be followed by another downgrade than by an upgrade. This indicates, Mr Altman says, that the agencies tend to dole out the bad news in small doses rather than savaging the bond issuer—who is, after all, their customer—all in one go.

Critics suggest a host of reasons why the agencies got Asia wrong. One is a reluctance to criticise companies and governments harshly, because they pay for the ratings. This charge, which is rolled out whenever a rating has proved over-generous, is hard to stand up. The raters can point to numerous cases where they have upset clients. A senior official of Japan's finance ministry recently accused Moody's of forcing Yamaichi into bankruptcy, and the Thai government attacked Moody's downgrading of its debt in April. Elsewhere, the Turkish government declared earlier this year that S&P would "definitely not get away" with cutting its rating.

There may be more to the criticism that the agencies do not like their ratings to get too far out of line with one another. Better to hang together than to risk a serious loss of reputation relative to competitors by going out on a limb and being wrong. But the agencies are not altogether wrong to behave this way. A rating upgrade can send a flood of money into an issuer's securities, and a downgrade can make it harder for an issuer whose problems may be minor to raise the money it needs to resolve them. This leads the raters to err on the side of caution.

Then there is the question of staffing. Wall Streeters tend to dump on credit-agency analysts, who earn far less than their peers at investment banks. "They are full of young guys in search of a good job, and old guys who couldn't get one," says one critic. For some reason, though, this shortcoming never seems to bother the Street when it needs reasons to buy bonds, only when it needs excuses to sell them.

Only one of the charges against the credit raters really sticks: that by centralising ratings in New York or London, they tend to miss developments on the ground. Centralised decision-making is important in making sure that the rating given on one company or country's bonds is not out of line with the rating on another's. But the consequence in Asia was that the agencies' ratings were set by senior people who greatly underestimated the region's political risks. In particular, agency executives admit, they failed to realise how hard it would be for governments to do the things they promised to do, such as closing weak banks.

It is true that despite such political misjudgments, the investment-grade ratings on Asian governments' debt have still to be proven wrong. None of the governments has defaulted, thanks largely to massive infusions of dollars from the IMF, and there is a good chance none will. But to interpret this as a testimonial to the accuracy of the ratings is specious. Investors around the world have long used ratings not just as a guide to the risk of default, but as a way to compare the riskiness of one bond with the riskiness of another. Indeed, much of the demand for ratings comes from investors who want to know whether this or that debt issue is attractively priced. Rating agencies may disavow that purpose, but it has long since become a source of their prosperity.

Whatever their mistakes, the rating agencies are unlikely to suffer. Asia's market turmoil, and its backwash in Latin America and Eastern Europe, have created plenty of new business opportunities. The greater the perceived risk, notes a joyful ratings executive in New York, the greater the demand for ratings.

## ILLUSTRATIONS

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